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CURRENCIES AND CREDIT MARKETS

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The essential fact about international co-operation is this: it has insulated America from the market disciplines that force unpleasant choices on everybody else. America's unwillingness to join in the co-operation has been seen as an overdue recognition of growing interdependence in the world economy. It has actually been the opposite: a way of refusing to face up to that reality.

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P.15, London

HIGHLIGHTS

The bells begin tolling from afar. The recent debacles of the Australian and British currencies has finally brought home the hazards of high-yielding economies.

Policy-makers of all these high-yielding countries confront an inevitable "Catch 22" the moment their economies begin to weaken. Will they defend their economies or their currencies?

For the time being, as inflation pressures increase, authorities are forced to stay tight. Only now, compounding that bias, is the additional task of defending fragile currencies thus greatly increasing the probability of overdoing monetary restraint.

The delaying tactics of high interest and high exchange rates means that the burden of monetary restraint squeezes the economies of the deficit countries from the external side rather than through domestic demand.

What we see today is the contemporary analogue of "competitive devaluations" in the 1930's - only with a complete reversal of premise. Rather than exporting unemployment, deficit nations today are trying to export the inflationary pressures of excess credit through artificially high currencies.

The globalization and new flexibility of credit markets has created an unparalleled tolerance for excesses and imbalance. Apostles of these huge capital inflows overlook two snags. A prime example of this gambit having already back-fired is Denmark.

The upshot is that there's is no monetary easing in sight even if some economies begin to weaken. Faced with rising late-cycle inflation and widening trade deficits, the central banks of the major deficit nations have little scope too fend off recession.

Only the timing is now uncertain given the notorious inertia of present day capital markets.

THE BELLS ALREADY BEGIN TOLLING FROM AFAR.

The recent debacle of the Australian dollar, diving suddenly some 10% within the time span of just a few days, has finally brought home the hazards of high-yield countries with large current account deficits. Less dramatic, but just as remarkable, has been the plunge of the British Pound. For the time-being, though, the chills of these secondary currencies benefit the U.S. dollar more than the low-yielding currencies of Japan and Germany.

As our readers know, we have long expressed the view that policy-makers of all these "high-yielding" countries (including the United States) will eventually confront an inevitable and teeth-gnashing "Catch 22". That uncomfortable point arrives when their domestic economies finally begin to weaken. Then a choice of battle-lines arrives - whether to marshall all resources in the defence of their domestic economies or currencies. Victory in both these battles becomes mutually exclusive.

For us, there has never been the slightest doubt over the ultimate choice. Once this fork of priorities arrives, the next development seems equally clear. After some bickering and grousing, one country after the other will sacrifice its currency on the altar of domestic and political expediency. Once the hard-landing of their currency finally becomes unavoidable, the focus will quickly turn to evading a hard-landing in their economies. But in this case too, we think it is inevitable that an economic hard-landing will follow that of the currency.

THE MODE OF ECONOMIC RESPONSE IS ALREADY BEING FASHIONED ELSEWHERE

Although international focus has recently centered on the pyrotechnics of Australia and Britain, the first casualty of this type already happened in New Zealand during mid-December. The moment of truth came much earlier there when Prime Minister David Lange finally threw in the towel and sacked his hard-line Finance Minister, Roger Douglas. New Zealand, like Australia, had been in the forefront of those countries whose authorities had sworn to wipe out inflation, almost regardless of recession and political cost. But as double-digit interest rates drove up the currency, New Zealand landed itself in the worst of all worlds: stagflation with prolonged recession and inflation still at 5%. The formerly huge current account deficit has improved sharply, but taking into account the buoyancy of world demand and the deep recession at home, the improvement has been grossly unsatisfactory.

Meanwhile, many people are thrilled with the idea that the globalization of financial markets offers all countries seemingly unlimited scope to finance the external deficits that may perpetuate under these current circumstances. We agree with one kernel that underlies this idea, namely that external deficits are

being tolerated much longer. But our conclusion differs. This tolerance for imbalance and excess by financial markets simply gives deficit countries a much longer rope to hang themselves with in the event of prolonged policy errors... nothing else. And the longer the rope for all of these countries, the greater and more grisly the final snap when the floor finally gives way.

This "happy-go-lucky" assumption, that global and flexible international credit markets can easily finance persistent deficits just by sucking in the savings of other countries, is very dangerous. These apostles of unlimited finance for unlimited excesses overlook two little snags: firstly, the vicious circle of compound interest, particularly at high interest rate levels; and secondly, the distortions and damages that this high-interest/high-exchange rate policy mix causes to the warp and weft of these deficit economies.

AN EXAMPLE OF LONG-RUNNING MALADJUSTMENT IS DENMARK

A good case study of another country that has over-borrowed its economy in recent years is Denmark. Relative to its size, Denmark has been the biggest international borrower in Europe. Its total foreign debt is equivalent to 40% of its annual GNP, a level as similarly extended as that of Brazil and Canada. Yet, Denmark's high interest rates kept foreign investors enthusiastic to lend more money all the while.

Denmark has now been in recession for three years running and finds itself powerless to do anything against it. Despite a sharp shrinkage in domestic demand, the current account deficit stays high, mainly for two reasons: one is the escalating interest bill; and the other is the fact that Denmark simply does not have the essential export industries to bring about adjustment through sufficiently higher exports.

But worst of all, regardless of deep recession, Danish authorities do not have the option to lower interest rates because of the country's extreme dependence on foreign capital. Instead, long-term interest rates are rising, even in the midst of recession.

DEMAND ADJUSTMENT IS DEFLECTED AND TRADE ADJUSTMENT THWARTED

There is a widely held view that large capital inflows are beneficial for deficit economies since it moderates the impact of domestic monetary restraint while the resulting currency appreciation rapidly suppresses inflation and improves terms of trade. It may indeed be true, as evidence suggests, that tight money loses some of its bite by the failure of long-term interest rates to rise with short-term rates.

But by the same token this policy mix of high interest/high exchange rates also means that the burden of monetary restraint and

economic contraction is shifted from the traditional interest-sensitive sectors of the domestic economy to the export and import-competing industries. Instead of primarily squeezing domestic demand, it squeezes the economy from the external side.

Conceptually, tight money is supposed to curb domestic demand and thereby also slow imports, which then improves the trade balance. Presently however, high interest rates have precisely the opposite effect on the trade balance. By drawing in foreign capital and thereby boosting currency-values, exports are made dearer and imports cheaper. Trade adjustment is turned upside down as the resulting exchange effects weaken exports while cheaper imports accelerate. True, this sequence also cools overheated economies, but only by worsening external imbalances.

This systematic abortion of the international adjustment process is clearly evident today. For example, in the case of Britain, export growth has slowed drastically from 5.4% in 1987 to 1% last year while import growth accelerated from 7.3% to 13%. Early last year, chancellor Nigel Lawson forecast a current account deficit of around 4 billion pounds. Instead, by the end of the year it had loomed four times as big. In Australia's case, export growth declined from 9.4% to 3% during the same period, while import growth shot up from 3.2% to 14%. Lately, the current account deficit has been running at an annual rate of A$18 billion, comparing poorly with the original official forecast of A$9.5 billion.

In America, too, exports that once propelled the economy in 1987 and 1988, have been marking time for well over six months. Between the third and fourth quarters of 1988, exports increased 2% and imports 4%. Actually, net exports have gone into reverse gear. After having accounted for more than half of real U.S. GNP growth in the first half of 1988, net exports were again negative in the second half.

In stunning contrast to the poor export performances of the deficit countries, is that the two major surplus countries, Japan and Germany, are enjoying a new export boom. In its recent report, the Bundesbank points out that German industry is flooded with export orders mainly reflecting a general investment boom in Europe. In the fourth quarter of 1988, German exports were up 11% from a year earlier. Meanwhile, imports rose 12% on the strength of domestic demand. Contrary to any economic sense, Germany with its overvalued currency is experiencing another export-led boom, while the expansions within deficit countries are being checked by rapidly deteriorating trade balances stemming from the mix of high interest and high exchange rates.

Yet in all these countries there is a perception that monetary tightness has been largely ineffective so far. What most people overlook is that tight money is indeed impacting their economies

very strongly, although through a very different channel than normal. This time a negative impact on overall demand is being delivered mainly via overvalued currencies and drastically widening trade gaps.

Nevertheless, a strong currency is precisely what policy makers in these countries want. They have recognized the quick and direct effects of rising exchange rates and appreciate them as an effective tool to check or reduce inflation. Without strong currencies and huge trade deficits, all these countries would undoubtedly have much higher inflation. From that perspective, lower inflation is literally borrowed from abroad in the sense that the currency effect on the opposite end tends to boost inflation in surplus countries whose currencies depreciate.

Actually, this device of exporting inflation through borrowed currency strength is the contemporary analogue of "competitive devaluation" in the 1930's under conditions of worldwide depression. Then, many countries, primarily Britain and the United States, deliberately depreciated their currencies in order to export unemployment through an improving trade balance. At the time, it was called "beggar-thy-neighbour" devaluation. The name implied that these countries manipulated their currencies to achieve higher employment at the expense of other countries.

Beggar-Thy-Neighbour Appreciation. What we see today is in principle the same game only with a complete reversal of premise. Under today's worldwide inflationary conditions, the game is to reap rapid gains against domestic inflation by driving a currency up - that is by "beggar-thy-neighbour" appreciation.

While such policies may seem justifiable from an individual country's perspective, they are clearly pernicious when viewed from a global perspective. Brought about in this way, a decrease in inflation is totally different than a decrease due to domestic demand restraint. Only the latter approach can bring about a net decrease in inflation for the world as a whole. Instead, these countries try to sidestep their own inflation pressures and throw them upon others.

Although more likely to increase global inflation, at best, such exportation of inflation through borrowed currency strength would only leave world inflation levels unaffected. But it does create damaging side effects. The most dramatic consequence of this game is that it creates a worldwide spiral of rising interest rates and exploding international debt. Worse yet, this ballooning pile of international debt is mostly the counterpart to overconsumption - both public and private. In a medium-term perspective, it is difficult to think of a more dangerous and potentially destructive strategy. It all hangs on a slender thread of confidence....the unlimited creditworthiness of the United States and Britain, the ring-leaders of the Anglo-Saxon inflationary world.

THE PERPETUAL MOTION MACHINE OF FINANCIAL EXCESS

How will this end? According to market folklore there is no end, cyclical or otherwise. It is argued that central banks have gained such a high level of expertise in spotting economic turning points and in fine-tuning the following landings onto a sustainable growth path, that serious recessions may very well have been exterminated once and for all. Others argue that hyper-sensitive credit markets will be vigilant in permanently keeping inflation at bay and that then, without inflation, economic growth can be perpetual. At long last, they claim, the financial equivalent of the perpetual motion machine has been discovered.

When we look at the high inflation rates and the gargantuan current account deficits of the United States, Britain, Canada and Australia, we can't help but wonder how these countries got there if under the watchful eye of expert central banks and vigilant capital markets. Rather, the irony is that only really dastardly policy mistakes under the auspices of careless markets could have created and financed the excesses and imbalances of such atrocious external deficits.

Few people indeed seem to realize that the credit excesses occurring in these countries over recent years are among the worst in history, if not the worst ever. Fortunately for these countries so far, grossly excessive demand growth - instead of forcing up domestic prices - has been largely transformed into ballooning trade deficits accommodated by the laxity of the global financial environment.

A testament to the intensity of the underlying inflationary pressures present in all these deficit countries, is that even though so much of their excess demand has been siphoned off into payments deficits, their domestic inflation rates are still running between 5% to 8%. It wasn't so long ago when President Nixon and his conservative advisers considered inflation of 4% grave enough to justify the radical act of wage and price controls. To the contrary today, inflation rates of 5%, 6% and 7% are regarded as achievements because these levels are still well below the double-digit inflation rates seen in the past.

The point we make is this: If there is any economic miracle in this new worldwide economic order, it certainly isn't to be found in the superiority of economic policies, as many people like to think, but in the indifference of financial markets to unprecedented imbalances and high inflation rates. In the past, to be sure, a higher inflation rate and incomparably smaller rises in the external deficit used to trigger a major currency crisis forcing the authorities of that respective country into drastic counter-measures. So, to speak of "vigilant markets" under current circumstances is really mockery of reality. If anything, markets

appear volatile and sensitive to single economic statistics but are totally insensitive to longer-running financial and economic fundamentals.

THE DREAM OF A SOFT LANDING

No doubt, there is a lot of wishful thinking reflected by financial markets that the Federal Reserve and other central banks of major deficit countries will somehow manage a "soft landing" - meaning restrained inflation and continued trade improvement without a recession and a plunge in their currencies. The main assumption underlying such hopes for a "soft landing" is that prevailing current account deficits are mainly a cause of cyclical factors and not deeper-seated structural issues. The authorities of all of these countries like to stress that large external deficits reflect nothing more than temporary excess demand and constrained capacity.

In their, view this distinction is crucial - the conclusion being the only thing needed to set things straight is a good dose of tight money so to eliminated excess demand. Then, it is thought, all the ingredients for a "soft landing" will smoothly fall into place. Shrinking domestic demand will slow inflation and import growth and in turn free productive resources required for higher exports. In other words, any decline in domestic demand would be supplanted by a resurgence in export growth.

The "soft landing" scenario further assumes that there will also be no such thing as a financial "crunch" due to capital outflows. Quite to the contrary, it is expected that the anticipation of lower inflation and falling short-term interest rates will trigger a stampede of foreign investors into the high-yielding bond markets of the deficit countries as they bet on the capital gains that will result from falling long-term rates. This new surge of capital inflows combined with accelerating trade improvement, it is thought, will strengthen the currencies of these nations.

All this sounds nicely plausible. The only trouble is that the realization of this scenario not only depends on a near miraculous fine-tuning of domestic demand but also on a number of other favourable conditions both at home and abroad that are simply beyond the control of resident policy makers. There are several questions: in the first instance, it still remains to be seen whether the central banks of the deficit nations may not misjudge a monetary tightening and consequently drive their economies into a deeper recession; then, the second question relates to the capacity and mobility of different economies to shift resources into exporting more and making do with fewer imports; and the third big question concerns the strength of demand in those countries that are supposed to absorb the sharply higher exports of the deficit nations.

FIRST COME THE CHALLENGES OF LATE-CYCLE INFLATION PRESSURES

It is becoming clearer by the day that the booming economies of the deficit countries have now entered the ending inflationary "blow-off" phase of an unusually long business cycle. In all these over-extended economies, the authorities now face the time-worn phenomenon that inflationary pressures tend to increase just at the time when the real economies begin to slow.

Employment Growth Statistics are the Least Reliable. While there are many signs that the U.S. economy is in the process of a sharp slowdown, financial markets have capriciously chosen to ignore them and instead to concentrate on the one indicator that has recently displayed extraordinary strength, namely employment. Lately, over and over again, the same refrain is heard that large employment gains reflect continued strong momentum in the economy and will further fuel strong consumer spending and robust domestic demand. If this is the latest sophistication in U.S. monetary policy, we can only express our bewilderment. It reminds us of the fact that as early as 1937, Wesley C. Mitchell and Arthur F. Burns, in a study for the National Bureau of Economic Research, had discarded changes in employment as an unreliable and generally lagging indicator of economic activity. Ever since, this verdict used to be common-place in cyclical analysis.

Average Workweek Makes More Sense. From all the various labour data, Mitchell and Burns identified only one as a reliable leading indicator - the average workweek in manufacturing. Ever since, this statistic has remained on the official list of early indicators. The unreliability of employment trends in assessing economic momentum stems from the combination of over-optimism on the part of business and an unwillingness to part with workers when labour markets appear tight. On the other hand, it is reasonable to expect that employers will change the length of the workweek much more promptly than the number of employees.

Fourth Quarter GNP Provides Insights: Cost Pressure. With the complete economic data for the fourth quarter of 1988 now available for the U.S., it becomes definitively clear that the surge in employment during this period was grossly out of "sync" with current output and demand growth. From an inflation perspective, the outstanding feature of the fourth quarter was a strong cost-push, not demand-push. Labour unit costs in the non-farm sector increased at an annual rate of 5.6%, after 3.7% in the third quarter. In manufacturing, labour unit costs rose 4.4%, compared with a 0.5% decrease in the prior quarter.

The first thought, of course, is that rising "wage inflation" caused by a tight labour market was the primary cause of higher unit labour costs. This interpretation appears wrong. The sudden

cost-push had little to do with accelerating wage rates but everything with the crazy employment boom. Because higher employment was not matched by a corresponding rise in output, a sharp slump in labour productivity ensued which in turn produced the apparent surge in labour unit costs. And note: while this employment boom may have been good for consumer incomes, it certainly wasn't helpful for business profits given the fact that final demand remained sluggish.

VITAL ECONOMIC SECTORS WEAKENING

Notwithstanding all the hysterical talk about the booming American economy, final demand again grew at a lacklustre annual rate of 2.5% in the fourth quarter, a pace very similar to the sluggish growth of 2% in the third quarter. As such, the third and fourth quarters pale in comparison to the final demand growth of 5.8% in the first half of 1988.

Next to the employment numbers, it is the alleged buoyancy of new factory orders, in particular those for capital goods, that are put forward as proof of the resiliency of the U.S. expansion. By now it should be well known that these capital goods orders are grossly misleading. Since mid-1988, general weakness has been masked by surging orders for civilian aircraft. As we have pointed out before, given already huge backlogs these aircraft orders will go into production over a period of many years.

As for the vital trend of electrical and non-electrical machinery demand, it is evident that new orders have been falling since August. Excluding aircraft and autos, the year-to-year increase in capital goods backlogs has fallen from 10% to 3.5% which hardly even makes up for intervening price inflation. Already, factory shipments of machinery have promptly followed the downward path set by orders. As Chart #1 comparing the growth rate of shipments and production with the growth rate of orders shows, production has been declining since September.

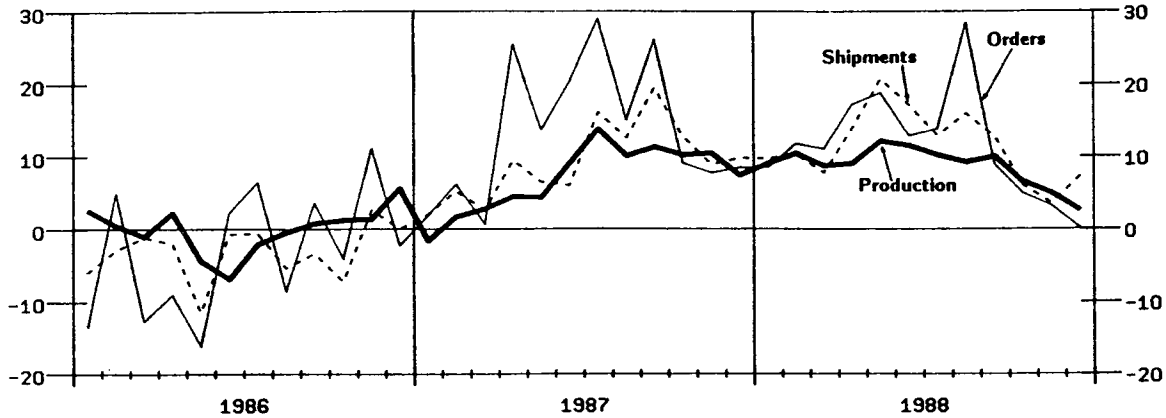
The weakness of machinery orders has lasted long enough to be graded as an established trend. In our view, this is a key indicator for the direction of the real economy because these orders relate to two key areas in the economy - capital spending and exports - and especially so considering that capital goods (without automobiles) account for almost 50% of U.S. exports of manufactured goods. At face value, this picture of lacklustre machinery orders looks bad enough but it seems outright disastrous when seen against the backdrop of a worldwide investment boom. That conclusion is obvious if one compares the new order bookings of the West German capital goods industries shown in Chart #2.

Chart #1

Capital Goods Excluding Aircraft:

Growth Rate of Orders, Shipments and Production

(6-month percent changes at annual rates)



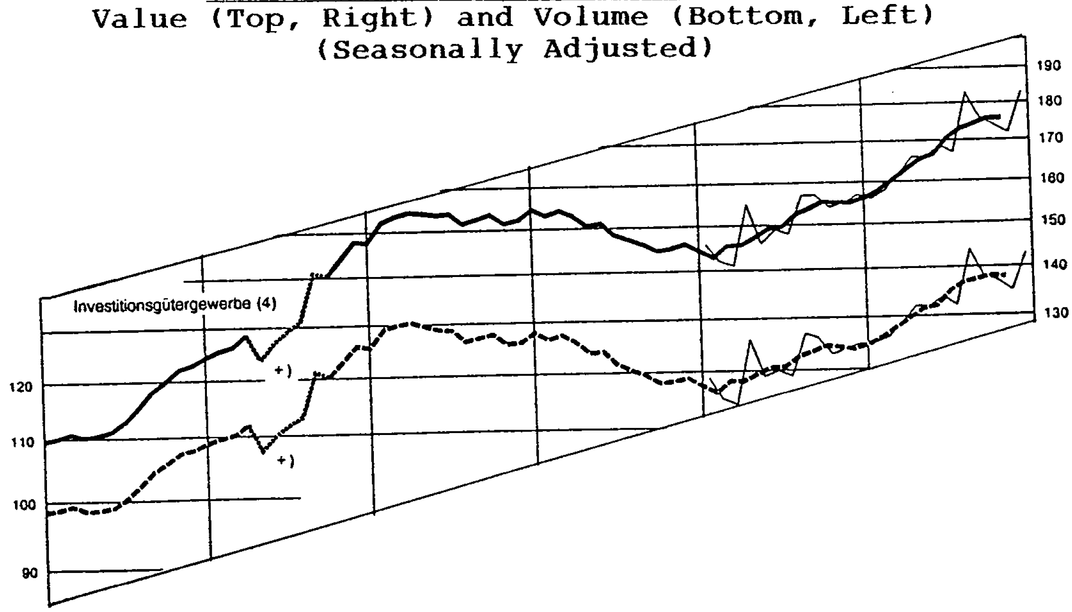
Sources: Bureau of the Census, Federal Reserve Board, Goldman Sachs.

Chart #2

West German Capital Goods Orders

Value (Top, Right) and Volume (Bottom, Left)

(Seasonally Adjusted)



Source: German Bundesbank.

U.S. TRADE PERFORMANCE IS QUESTIONABLE

The flagging performance of U.S. capital goods industries brings us back to an oft-cited argument explaining the recent poor performance of U.S. merchandise exports - the argument that capacity constraints are the main cause. The case of U.S. machinery orders and production speaks strongly against this assumption and all the more so since capital goods are the backbone of U.S. manufacturing exports.

Last but not least, we have to add that U.S. manufacturing industry is not alone in hitting capacity limits. As a matter of fact, many other countries, above all Germany, France and England, record even higher capacity utilization rates than the United States. Yet German exports continue to boom at an accelerating pace.

Optimists on the U.S. trade deficit have taken comfort from the fact that it has declined from $170.3 billion in 1987 to $137.3 billion in 1988. They look forward to a further gradual correction in parallel with weakening domestic demand over the coming years. The key assumption behind this optimistic view, as already mentioned, is that the large U.S. trade deficit has mainly to do with excessive U.S. demand growth and very little or nothing with a lack of international competitiveness or an overvalued dollar.

The Sources of Past U.S. Trade Improvement. No doubt, the U.S. trade balance improved greatly last year. But exactly how did that improvement arise? Was it the fruit of dollar depreciation and increased international competitiveness? If these are the correct reasons, the proof would have to show up mainly in manufactured trade, because that's where competitiveness counts. Besides, manufactured goods are the largest single element in the U.S. trade deficit and also the key vector in its erosion over the last seven years.

From 1981 to 1987, manufacturing trade moved from a surplus of $15.5 billion to a deficit of $153.7 billion. Since that point how much of any trade improvement has been accounted for by manufactured goods? A close look reveals a shocking surprise. In 1988, this deficit component of the trade balance improved from $153.7 billion to $146.8 billion or some $6.9 billion. That's peanuts when compared with a U.S. trade turnover (total imports plus exports) of $575 billion in manufactured goods last year. And all this under conditions of booming demand outside the United States.

Where then did the trade improvement mainly come from if not from manufactured goods? First, from cheaper oil; and second, from soaring prices of agricultural products. Both, of course, have nothing to do with U.S. competitiveness.

Oil imports rose in volume terms by about 10% last year, but because the average price of oil per barrel fell by 20% from $17.21 to $14.11, the oil import bill declined from $44.8 billion to $41.8 billion. Presently however, oil prices are running about 20% above year-earlier levels. At the same time, oil import volume in January was up 18% as U.S. consumption rose 2% and U.S. domestic oil output fell 4% from January 1988.

Agricultural exports also made a contribution increasing $8.8 billion or 30%. In this respect, the drought was very helpful since it helped reduce the U.S. trade deficit by boosting prices. The average price of exported corn increased 38%, soy beans 33%; wheat 20%; and cotton 20%. As should be obvious by now, all these trends and statistics clearly point to one and the same conclusion - the general effects of improved competitiveness in manufactured trade are nowhere to be found.

THE CHANCES FOR A SOFT LANDING ARE SLIM

Back to the original question of whether or not the major deficit nations may be able to engineer a "soft landing" - the implication being that inflation and the external deficits are brought under control without prolonged recession.

In the first place, let us note that such a smooth transition from overexpansion and overheating to sustainable growth has never before succeeded. The typical problem at the tail end of a cycle is that inflationary pressures tend to intensify while the real economies are already slowing. Rising cost pressure resulting from sharply weakening productivity has at this stage always forced the central banks to "err on the side of restraint".

All this is depressingly familiar, but this time the policy conflict and the risks of overkill are compounded by the fact that all these deficit countries have become excessively and dangerously dependent on inflows of foreign savings. With inflation rates at thresholds that cause alarm, the central banks will be particularly fearful of a falling currency. While it was tempting to use overvalued currencies as a useful means to suppress domestic inflation, such "beggar-thy-neighbour" appreciation was bound to end up making the central banks of these countries hostages to exchange markets and foreign interest rates.

All these deficit countries suffer from various degrees of excess borrowing and spending as indicated by their high inflation rates and their large payments deficits. But, even though the mix of manifestations may be slightly different, their problems are basically exactly the same. Therefore, we think that their individual experiences offers some clues as to what all of them will face.

Optimism Continues to Carry the Day, But Facts Say Otherwise. There is a widespread perception that the economies of these deficit nations are enormously resilient and that high interest rates are hardly biting. In our view, these economies will (rather sooner than later) suddenly and sharply slow down because they will be squeezed by two formidable and depressing factors at play; first, the lagged effects of drastic monetary tightening; and second, the downward pressure from worsening trade balances.

As explained in some detail, the U.S. economy is much weaker than most people think, in our view. Meanwhile, more and more data signal the onset of an imminent and drastic slowdown of the British economy. It's only weeks ago that the consensus still saw a British economy bursting of strength from buoyant consumer demand and an investment boom. Now all of a sudden, the realization sinks in that retail sales volume has been virtually flat since mid-1988. Consumer confidence surveys are profoundly depressed. Industrial production plunged by 1.8%, and the year-over-year rate of increase declined to 1.5%.

Turning to the trade balance, the picture could hardly be bleaker for Britain. Imports of manufactured goods are rising at a rate of 18%, while export orders have been declining in recent months. To us, that is particularly alarming because this trade deterioration is happening under the most favourable international conditions with large parts of the world economy - above all Continental Europe and the Far East - still booming.

All this suggests to us that there is more to the British trade deficit than just excess demand: namely an overvalued currency and lack of international competitiveness. What we presently see in Britain we shall soon see in the United States, Canada and Australia: the beginning of the inevitable monetary policy "overkill". All these countries have at long last entered the critical phase of a most violent "stop-go" cycle fuelled everywhere by an unprecedented borrowing binge that has resulted in unparalleled imbalances.

FEW SILVER LININGS

There is widespread hope that softening economies will usher in with them lower inflation and interest rates. Unfortunately, most of the time, both tend to rise just before recession hits, partly because of the phenomenon of late-cycle cost-push and partly because central banks and the markets are generally late in recognizing the economic turning point. Those tendencies of central banks are likely to be reinforced given the fact that all these countries rely heavily on a strong currency to control inflation. For these reasons, it seems pretty likely that these central banks will be particularly reluctant to relax their monetary restraint before there is clear evidence of lower inflation.

The upshot is that there is no easing of monetary policy in sight even if some economies begin to weaken. In the meantime, the

expectation that intensifying inflation risks in the United States will require still higher interest rates is giving support to the dollar. Paradoxically, growing inflation worries add to the strength of currencies on the assumption that it will necessitate higher interest rates.

Yet, all these currencies remain vulnerable to disappointing trade figures. That's what suddenly rocked the British pound and the Australian dollar. While the exchange markets seem exclusively fixated on interest-rate differentials, in addition there has been an underlying assumption and expectation that monetary tightening would produce domestic and external adjustment.

To the contrary is the fact that the current account deficits of all these countries have widened in the second half of 1988, in some cases dramatically. But this has not become a major concern yet, because policy makers and markets are counting on slowing demand to moderate imports and ease capacity constraints which would then permit faster export growth.

No doubt, there is a kernel of truth in this reasoning, yet it's grossly simplistic. Experience and theory have taught that such a transition depends on the outcome of a multitude of factors. In scientific language, it depends on the elasticity of supply and demand at home and abroad. Assuming that domestic demand in these countries will shrink, what is their potential supply of exportable goods that other countries would want to buy at given prices? That leads to the question of the pressure and the structure of foreign demand.

SUMMARY CONCLUSIONS

One final point we wish to re-emphasize: to us it makes extremely negative reading that the current account deficits of all these countries have widened in the second half of last year even against the backdrop of booming demand in the rest of the world. In this period, real domestic demand growth in Europe and Japan, collectively reached a 4.5% - 5.5% annual rate, more than twice the rate of expansion in the United States. But now their demand is bound to moderate.

What are the main danger points in this situation and in present policies? The first essential point to see is that the economies of the United States, Britain, Canada, and Australia, are extremely vulnerable because their apparent economic strength results from unprecedented credit and spending excesses.

But the fact that these excesses were mainly reflected in soaring external deficits, rather than in runaway domestic inflation, has created an illusion of stability and soundness - and fostered more excesses. Most perverse of all is the prevailing view that huge deficits and rising inflation really reflect robust and dynamic

economies.

In reality, these trade deficits are inexorably and progressively sapping domestic production and income growth in the trade-sensitive manufacturing sectors. All four economies are virtually living on borrowed time. Therefore, their economic slowdowns, once they arrive, could be quite dramatic.

There is much talk of the coming rally in the bond markets of these countries if a recession should materialize. There may be one in the short run, but in the longer run everything depends on the currency markets and on how foreign investors will perceive ongoing developments in these countries.

In our opinion, foreign investors will be shocked when they finally realize the extent of the mess that these countries have made for themselves. In short stagflation: incipient recession associated with high inflation rates and stubbornly high external deficits.

Only then, begins the really critical time for these countries, their currencies and their financial markets. And not to forget that budget deficits will then rise sharply, too. Consequently, the brunt of slowing capital inflows will fall heavily on their financial markets, generating upward pressure on interest rates and downward pressure on currencies.

There is an element of inevitability in all this due to the fact that imbalances have been allowed to become so large. Sadly, very few recognize the grave trouble that rapidly nears. Only the timing is now uncertain given the notorious inertia of present day capital markets.

Paradoxically, for the time-being, the spectre of rising inflation and monetary tightening is still being imaginatively pressed into an optimistic interpretation for currencies and economies. Basic perceptions still remain fairly optimistic thus ensuring that most will be caught entirely unaware.

Under the given conditions of high inflation rates and large external deficits, the central banks have little or no scope to fend off recession. Worsening inflation in the deficit countries now begins to frighten and dominate the attentions of markets and policy makers and virtually compels them to "over-kill" their economies.

Poorly misunderstood is the fact that inflationary pressures always appear to intensify after the point that economies already begin slowing. It should come as no surprise that inflation pressures can continue to haunt for many months yet even though economies may start to show dramatic signs of weakness.

ERRATUM. Readers, please note that a misprint occurred in our February letter. On page 9, paragraph 3, line 6 the text should have read "plus $4.3 trillion" as apposed to "billion". We apologize for any confusion that may have resulted.

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